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Economic Update: Australia
July 2021

Morningstar Research
July 23, 2021

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Outlook for Investment Markets

In July there was a global increase in concern about the economic outlook, largely linked to the spread of the Delta variant of the coronavirus. Its high level of infectiousness has meant it poses greater risk to unvaccinated populations. Markets appear to be recovering from their initial anxiety, which had sent equities lower and had triggered buying of safe haven bonds. Various commentators have said that investors have taken comfort from the lessons of 2020, when there was an initial sell-off on COVID-19's appearance, but a subsequent strong recovery. Looking forward, the global macroeconomic outlook (excluding in the emerging markets) is still positive for growth assets, but as the initial sharp V-shaped rebound from COVID-19 winds down, there may be further episodes of volatility. The two main uncertainties remain further twists in the COVID-19 story, as well as the outlook for inflation. If current price pressures are not merely transitory, central banks may still withdraw the liquidity that has helped sustain the valuation of growth assets. In Australia, the big news has been the unfortunate outbreak of a new round of COVID-19 and the re-imposition of lockdowns and interstate travel restrictions. Nobody has a good track record of picking what COVID-19 is going to do next or what the economic impacts might be, but a replay of something like 2020 would suggest reasonable grounds for believing in a reasonably rapid recovery, even if the near-term impact is sizable.

Australian Cash and Fixed Interest — Review

Short-term interest rates have remained very low, and the 90-day bank bill yield continues to trade at just above zero. Bond yields, on the other hand, have dropped, following the lead of the U.S. market, and the local 10-year Commonwealth bond yield is now 1.21%. The Australian dollar has weakened, and year to date it is now down 3.2% in overall trade-weighted value.

Australian Cash and Fixed Interest — Outlook

At its July 6 monetary policy meeting, the Reserve Bank of Australia, or RBA, had taken a very small initial step toward scaling back its degree of monetary policy support, when it decided to ease back its programme of bond buying (which keeps longer-term bond yields down) from AUD 5 billion a week to AUD 4 billion. Although any move to a formal raising of interest rates from their current low target levels (0.1% for both the cash rate and the three-year bond yield) was still a distant prospect, in all probability it would likely have continued to inch its way back from peak monetary policy support if the economic recovery had continued to unfold. But all the RBA's calculations will have been upset by the latest COVID-19 outbreaks, and any further moves are now unlikely for some time. If anything, policy support may be scaled back again to cope with the current problems.

In the immediate near-term, the COVID-19 outbreak is likely to dominate everything else, and bond yields could well track lower if investors become more concerned about the economic outlook or if the RBA moves to easier monetary policy (or both). On the other side of the lockdowns, assuming eventual

containment and a quick recovery similar to that out of the 2020 outbreak, bond yields are likely to resume their close link to developments overseas, particularly in the U.S., as investors both there and here will be grappling with the same questions. Are current inflationary pressures transitory, and linked to shortages due to the likes of COVID-19 disruptions to supply chains and to surges in post-lockdown consumer demand, in which case central banks, including the RBA, need not respond; or are they more permanent, perhaps reflecting the cumulative effect of years of very easy monetary policy, in which case central banks are likely to have to start stepping back from ultra-supportive settings?

There are strong proponents of each viewpoint, and the jury is out on what the ultimate outcome will be. At this point, a reasonable assessment is that not all the price pressures will prove transitory, and that some modest rise in local bond yields looks plausible. Although there are forecasts in the marketplace suggesting larger moves, Westpac Bank's pick that the 10-year yield will be 2.0% in a year's time appears to be a reasonable prediction.

The outlook for the Aussie dollar remains linked to the global appetite for investment risk--it is one of the currencies that tends to do better when prospects for global growth are good and investors are more prepared to take on active foreign-exchange positions (a risk-on environment). The dollar got sold down when investors became, at least temporarily, more worried (and risk off) in July, and so far, it has not recovered and has clearly not been helped by the local outbreak of the pandemic. On the assumption that the world economy does indeed carry on its recovery from COVID-19, and that the Australian economy emerges reasonably quickly from the current lockdowns, then the odds are that the Aussie dollar will eventually appreciate. For example, currently both the National Australia Bank and Westpac see the Aussie at U.S. $0.82 in a year's time, compared with its current 73.2 cents.

Australian and International Property — Review

At least until the latest COVID-19 outbreaks, business conditions had been robust in Australia, and the A-REITs had been doing well. Even after the latest volatility, investors are still ahead, and year to date the S&P/ASX 200 A-REITs Index is up 5.8% in capital value and has returned 8.0%, including dividends.

Global listed property has been strong overall, but with marked regional variation. The FTSE EPRA/NAREIT Global Index in U.S. dollars is up by 14.5% in capital value and has delivered a total return of 16.7%. As with the wider global equity market, however, the outcome has been heavily influenced by the U.S., where the REITs have returned 27.4%--excluding the U.S., global REITs have returned 6.7%. Also mirroring the global trend, emerging markets have been less able to cope with COVID-19 than their developed counterparts, and emerging-markets REITs have returned a loss of 5.3%.

Australian and International Property — Outlook

Before the latest COVID-19 outbreaks, property had been on the mend. The latest (June quarter) ANZ/Property Council of Australia survey, for example, had shown that confidence had risen back to pre-COVID-19 levels. By subsector, industrial property and retirement villages clearly led the pack, and even though capital-value expectations were still negative for retail, office, and hotel property, they were a good deal less negative than they had been in pandemic-affected 2020.

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The impact of the latest round of COVID-19 cases and lockdowns is hard to call. It could be (as discussed in the Australian equity section) that the prospect of a sharp rise in vaccination rates in coming months will lead investors to focus on the upside of post-lockdown recovery in 2022. But it is also plausible that the latest episodes will intensify some of the structural challenges that COVID-19 either set in play or accelerated. In the office market, for example, JLL's latest (June) Tenant Perspectives said that conditions are tenant-friendly, as "Large corporates are leveraging the hybrid working model to decrease the amount of core space they are committing to ... The shift to work from anywhere is seeing a fundamental change in how the office is being used." And structural change is also probably further increasing the attraction of industrial and increasing the challenge for retail. Knight Frank's July research insight on urban logistics said that "despite the phenomenal growth in online retail sales, online sales still only account for a small amount of overall sales in Australia. This suggests two things. Firstly, Australia is still in the early stages of this transition and two, that there is still a strong need for the centralised larger footprint and dark stores ['a retail outlet or distribution centre that caters exclusively for online shopping' - Wikipedia] to help businesses scale." There may be opportunities, as there were in 2020, to pick up temporarily oversold property assets, but otherwise the increased uncertainties facing the sector suggest that a defensive subsector approach may be the best holding pattern until the post-COVID-19 landscape becomes clearer.

Overseas, the prospects for the REITs face the same set of sectoral structural challenges. Industrial will continue to be in the prime spot, and traditional retail is under pressure. CBRE, in its June Global E-commerce Outlook report, calculated that in 2015 the global retail market was worth USD 12.6 trillion, of which only 8%, or USD 1.0 trillion, was online. By 2020, online shopping had risen to 18% of the spend and was worth USD 2.4 billion, and CBRE forecasts that it will continue to grow very strongly, to USD 3.9 billion by 2025, which will require some 138 million square metres of additional logistics space to service it. As a rough guide to what that means in practice, it amounts to roughly 3 times all the office space in Manhattan. The traditional office will also be under pressure, although at this point it is not obvious to what extent. In the U.S., the percentage of employees working from home was as high as 37% in May 2020, at the height of the pandemic, and is down to around 15% now, which suggests that as further progress is made with vaccinations, working-from-home numbers will drop even further. This sounds like good news for office landlords, but the bulk of the analysis of post-COVID-19 work arrangements nonetheless suggests there has been a change of mindset for both employers and employees on how best to organise post-COVID-19 work processes, and the full-time office scenario will not look like it used to. With global REIT prices now reflecting the value of the unexpected V-shaped recovery, further large rises in REIT prices look less likely, and again the best approach may well be to take a defensive sectoral-focused holding position.

Australasian Equities — Review

Australian shares have done well year to date: The S&P/ASX 200 Index up is by 10.1% in capital value and has returned 12.0% including dividends. The banks have done their bit, with the financials (excluding the A-REITs) up 16.2%. Two other prime beneficiaries of the sharp rebound from COVID-19 have also performed strongly: the miners, which have ridden the coattails of global recovery to a 10.7% gain, and

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consumer discretionary stocks, which have benefited from post-lockdown spending and are up 18.0%. Investor focus on cyclically sensitive winners has meant that growth sectors like IT have lagged, and IT shares are down 5.2% (though still up 25.8% on a year ago).

Australasian Equities — Outlook

Businesses had been doing very well before the latest COVID-19 outbreaks. The latest (June) quarterly business survey run by National Australia Bank, or NAB, showed a very strong economy. NAB said that "Business conditions were still in negative territory in Q3 2020, and now, three quarters later, they were at a record high, a testament to how rapid the recovery has been from last year's recession." The suite of performance indexes run by Ai Group similarly showed that manufacturing, services, and construction had all been growing robustly in June.

The latest outbreaks and lockdowns have transformed the near-term outlook for the worse. As the outbreaks have reminded us, forecasting where COVID-19 might appear, and in what form, and what the immediate and longer-term economic and financial impacts might be, has proved to be a very difficult exercise, and estimates this time round might also be well off the mark. But at this early stage forecasters are being reasonably upbeat about the outlook beyond the immediate lockdowns, and they are focusing on progress with vaccinations, fiscal support, and the experience with COVID-19 in 2020.

NAB, for example, says that "We assess the lockdown impact as again likely only to be temporary, with the lessons from prior lockdowns being that activity rebounds sharply when restrictions are eased. Accordingly, we would expect a reasonable activity bounce back to occur in Q4 and Q1 2022, especially given announced government support. The reality though of a prolonged lockdown in Sydney is an acute reminder that Australia's aggressive suppression strategy means lockdowns remain a risk until vaccine penetration lifts enough for Australia to start to live with the virus. The government is currently waiting on modelling to determine these vaccine thresholds with State Premiers having previously nominated 70-80% of the adult population as a benchmark. NAB's back of the envelope calculations suggests we could get to 60% adult vaccination by mid-September, 70% by mid-October and 80% by mid-November, assuming low vaccine hesitancy and no supply chain bottle necks."

Westpac has a similar view. It says that "Optimistically, Australia can be on track for 60% fully vaccinated (compared to the current 10%) by late November with the possibility of moving further (although with 25% of the population under 20 there will be some limit to the proportion of population vaccinated). Australia's adult population could become one of the most highly vaccinated globally by the first quarter of 2022. That would be a game changer for Australia and the confidence that would earn from markets." The bank also said that "Markets are also likely to overestimate the damage done to the Australian economy over this period. Governments are committed to strong support, particularly given the sharp improvements in the underlying fiscal position, momentum outside NSW is strong while there is ample evidence that economies bounce back from snap lock-downs on government support and pent up demand."

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If markets focus on the longer game and come to focus more on a cyclical recovery along the lines expected by NAB and Westpac in a post-COVID-19 2022, then equities may emerge from this latest episode quite well. But Westpac is also surely right to mention the risk of "significant volatility" along the way.

International Fixed Interest — Review

July's volatility brought increased demand for bonds as investors looked for safer-haven assets against the risks of the Delta variant of COVID-19. In the U.S., for example, the yield on the 10-year Treasury note dropped to just below 1.2% on July 19, the day of maximum investor anxiety. As anxiety has receded, the yield has started to move back up again and is now just below 1.3%. The latest moves have not done much to affect the year-to-date performance of bonds, which mainly has been driven by the rise in bond yields and associated capital losses, which occurred in the March quarter. Year to date the Bloomberg Barclays Global Aggregate Bond Index in U.S. dollars is down 2.5%, with global government bonds down 3.7% and global corporate bonds, better protected by their higher yield, down by 1.0%.

International Fixed Interest — Outlook

By far the biggest issue for the asset class and for the financial markets more widely is the outcome of the intense debate over whether current inflationary pressures are transitory, permanent, or a bit of both. If transitory, then the world's central banks are likely to leave their current stimulatory monetary policy settings unchanged; if partially or largely permanent, then there is likely to be some gradual withdrawal of liquidity, which would both depress bond prices and, via higher interest rates, threaten the valuations of other asset classes.

In the U.S., for example, consumer price inflation ran at a remarkable annual rate of 5.4% in June, the fastest rate in almost 13 years. The pro-transitory interpretation is that the outcome was a) partly artificial, in that today's more normal levels of prices were being compared with the depressed levels of the depths of COVID-19 last year; and b) the sharp V-shaped recovery out of COVID-19 will abate, reducing temporary mismatches of supply and demand as it subsides. That is largely the Fed's view--its chair Jerome Powell has said that the pandemic had created "just the perfect storm of high demand and low supply," and that inflation "should partially reverse as the effects of the bottlenecks unwind." It is also the majority view of fund managers. In the June fund manager survey run by Bank of America Merrill Lynch, or BAML, 70% of fund managers felt that current inflation is transitory.

Given the strength of the global economy, however, it seems unlikely that the entirety of the current inflationary pressure is transitory, and it is worth remembering that even before COVID-19 appeared, the Fed had got consumer inflation running at around 2%, its target rate. Even if inflation subsided all the way back to where it was prepandemic, U.S. bondholders would be running losses in after-inflation terms.

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Nobody is expecting an explicit move from the Fed on interest rates anytime soon. The futures market, for example, thinks there is a 75% probability that the target range for the Fed funds rate will still be 0% to 0.25% in a year's time. But either because investors gradually cease to be willing to run after-inflation losses, or because the Fed starts to wind back its bond-buying programme, the likelihood is that bond yields will gradually rise. The latest (July) Wall Street Journal poll of U.S. forecasters found that the median 10-year yield is expected to be 1.8% by the end of this year and 2.1% by mid-2022. As this month's developments showed, bonds still have useful insurance value if COVID-19 or other shocks materialise, but a central scenario of ongoing global growth and higher inflation is a cyclical background where bonds are unlikely to do well.

International Equities — Review

At time of writing, equity markets were volatile. Investors became more concerned about the potential impact of COVID-19 and the scope for the new and more infectious Delta strain to lead to a new surge in cases, with the human and economic costs. Monday, July 19, was a difficult day: In the U.S. the S&P 500 dropped by 1.6%, and globally the MSCI World Index in U.S. dollars also dropped by 1.6%. Within the overall share weakness, investors were moving back into the more defensive companies, such as supermarkets, which had done well during the first round of COVID-19 disruption, and away from the most cyclically exposed companies, such as airlines. At time of writing, however, shares had bounced back, with the S&P 500 gaining 1.5% and world shares gaining 1.0%, and investors were buying back the COVID-19-sensitive sectors sold the previous day.

The net effect is that world shares are still well ahead for the year, with the MSCI World up 11.7%. Performance in the developed economies continues to be dominated by the U.S. market, where the S&P 500 is up by 15.1% and the Nasdaq by 12.5%–excluding the U.S., world shares are up by 5.8%, with European shares doing well (FTSE Eurofirst300 Index up 12.2%), but Japanese shares lagging (Nikkei down 0.2% in yen, and the yen down 6.0% against the USD). Emerging markets are up by only 1.5% year to date, with a small loss for the core BRIC--Brazil, Russia, India, China—bloc, which is down by 1.7%. While India and Russia have done well (MSCI India is up 11.1%, MSCI Russia is up 11.0%), Brazil has been quiet (MSCI Brazil is up 2.0%) and Chinese shares have been weak (MSCI China is down by 6.2%).

International Equities — Outlook

The unexpectedly strong global recovery from the COVID-19 disruption is still an important driver of equity performance. The U.S. reporting season for the June quarter is just getting underway, and the latest FactSet roundup of share analysts' expectations for the quarter's performance by the companies in the S&P 500, for example, is for a startlingly large 69.5% increase in earnings on a year ago.

Companies are also very optimistic about the economic outlook. IHS Markit runs a global business outlook survey three times a year. The latest one was conducted in the second half of June, and it was very encouraging, at least for the developed economies--emerging markets with more limited medical resources are having a much harder time combating COVID-19. The survey found that "Vaccine progress and expectations that COVID-19 restrictions will continue to be lifted as the pandemic recedes pushed

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global business confidence to a seven-year high in June. Companies intend to replace staff who were dismissed since the onset of COVID-19 amid capacity expansion efforts and predictions of a rebound in demand. Hiring intentions were the joint-strongest since the global financial crisis. The upturn in optimism coincides with our forecast of a 5.8% expansion in global real GDP for 2021, which should then soften to 4.7% in 2022 and settle at 3.1% in 2023. Naturally, there remains downside risks that new COVID-19 variants could lengthen the pandemic and threaten the recovery."

As the IHS Markit forecasts suggest, however, the unexpectedly resilient post-COVID-19 boom that has led to sharp rises in equity markets is gradually winding down, and the FactSet analysts' forecasts show a similar pattern. Profits for the S&P 500 companies are expected to grow by 36.7% this year, but to slow down to 11.0% next year. And fund managers also reckon that the best of the rebound is behind us. The BAML July fund manager survey showed that 47% of fund managers expect the global economy to improve, compared with a peak of nearly everyone (91%) in March, and there was a similar drop in the percentage expecting profits to increase--to 53% from 89% in March.

Even with the expected slowdown from peak rebound, business conditions still look helpful for equities: three quarters of the fund managers think 2022, even if not as buoyant as 2021, will still be a better year than most. But where the overall boom of 2021 was strong enough to override pretty much any bad news, slower growth in 2022 does not leave quite the same comfortable margin to absorb shocks, and now higher share valuations also make equities more vulnerable to adverse surprises. As Peter Warnes, Morningstar's head of equity research in Australia and New Zealand, put it in a recent interview on the Morningstar website, "Given where valuations and markets are, and given that I think that a lot of the tailwinds, they are luffing now, they're not really right behind you. The fiscal and monetary stimuli, and support programs are behind you, they're not going to help you going forward. And so, if that's the case, and if you've got slowing GDP growth, coming at you, I think that you should be--the margin of safety in the market at the moment is absolutely wafer thin." Overall, the macroeconomic backdrop for corporate profits and equity performance is still supportive, but we are likely to see further episodes along this month's lines where investors question the sustainability of corporate earnings.

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